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No. 77-1324

In The

Supreme Court of the United States

October Term, 1977

Anderson, Clayton & Co.,
Petitioner,

v.

United States of America,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

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The petition for a writ of certiorari raises two related contentions: first, the Secretary's new regulation, which was issued while this case was pending on the government's appeal, may not be applied retroactively as a basis for reversing the decision of the district court (Pet. 8-12); second, the new regulation may not be applied retroactively at all, for it repealed the rule prescribed by preexisting regulations (Pet. 12-13). The government's brief in opposi-

tion says very little about these contentions,[1] but the little it does say is inaccurate and misleading.

a. The government apparently concedes the correctness of the legal theory underlying the petitioner's first contention, for the brief in opposition fails to argue that a court of appeals may reverse a district court's judgment on the basis of the retroactive application of a Treasury regulation that was not promulgated until the case was pending on appeal. Instead, the government asserts as a fact that the court of appeals below reached its decision to reverse independently of "whether or not the Commissioner [*sic*] had promulgated a regulation" (Br. in Opp. 4; see also *id.*, at 6). That assertion seriously misrepresents the rationale of the decision below.

In considering the issue of the proper computation of petitioner's foreign tax credit for the taxable year 1964, the court of appeals began with the observation that although the statute failed to provide an answer, the Secretary had sought to do so in 1975 by issuing the new regulation, Treas. Reg. § 1.902-3(d)(1) (Pet. App. B-12). The court then took up and decided three separate questions seriatim: whether the new regulation applied to the type of distribution petitioner had received from its foreign subsidiary (*id.*, at B-12 to B-13); whether the regulation could be applied retroactively (*id.*, at B-13 to B-26); and whether the regulation was substantively valid (*id.*, at B-27 to B-32). The court concluded that "[h]aving found the regulation both valid and retroactively applicable to the case at bar, we must reverse the district court's judgment on this issue" (*id.*, at B-32). It therefore is clear that

[1] The bulk of the government's argument (Br. in Opp. 8-13) is devoted to an effort to establish the substantive validity of the new regulation. That issue is not before the Court. The petition assumes *arguendo* the validity of the new regulation and argues only that the regulation may not be enforced retroactively.

the new regulation was central to the court's analysis and indispensable to its decision.[2] Indeed, the court emphasized the decisive role played by the Secretary's regulation by stating that even though the rule set forth therein had "disadvantages" (*id.,* at B-31, n.32), "the proper dividend sourcing rule represents a policy choice that Congress has delegated to the Secretary, not the courts, and we decline to upset his considered choice" (*id.*).

b. In attempting to dismiss the conflict between the decision below and *Commissioner* v. *Goodwyn Crockery Co.,* 315 F.2d 110 (6th Cir. 1963), the government both misdescribes the holding of *Goodwyn Crockery* and mischaracterizes that holding as *dictum.*

The government (Br. in Opp. 7, n.3), like the court below (Pet. App. B-17, n. 18), persists in describing *Goodwyn Crockery* as standing for the erroneous proposition that a Treasury regulation may never be applied retroactively. That is not the rule of *Goodwyn Crockery.* That case stands for the narrow proposition correctly and approvingly ascribed to it by the Second Circuit in *Chock Full O'Nuts Corp.* v. *United States,* 453 F.2d 300, 302-303, n. 6 (1971): "courts . . . [will] decline[] to give retroactive effect to regulations or rulings of the Commissioner . . .

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[2] The government bases its description of the holding below upon two short footnotes in the lengthy opinion. In one footnote, the court simply stated that the Secretary's assertedly consistent adherence to the rule belatedly set forth in the new regulation would have constituted a "powerful argument" for the government in the absence of the regulation (Pet. App. B-22 to B-23, n. 24). That statement amounts to considerably less than an alternative holding. The second footnote disclaimed any intent "to suggest that . . . without the recent promulgation of [the new regulation], the taxpayer's position would prevail" (*id.,* at B-12, n. 15), and the court went on to indicate that it was impressed by some of the arguments available to the government even apart from the new regulation (*id.*). The court stopped short, however, of elevating those isolated remarks to the status of an alternative holding.

when litigation involving the area clarified by the regulation ha[s] already begun. . . ."[3] The decision below violates this rule.

There is no basis for the government's unexplained assertion (Br. in Opp. 7, n. 3) that the articulation of this rule in *Goodwyn Crockery* was mere *dictum.* The issue in that case was whether a corporation had continued to carry on substantially the same trade or business after a change in ownership of all its outstanding shares. The corporation had relocated its entire business premises to a different state, dismissed all but two of its former employees, and retained only 40 percent of its previous customers. 315 F.2d at 111-112. The Tax Court had sustained the taxpayer's contention that the same trade or business had been continued. On appeal, the government relied upon a newly adopted regulation, Treas. Reg. § 1.382 (1962). That regulation provided, *inter alia,* that "[a] corporation has not continued to carry on a trade or business substantially the same as that conducted before [a major change] in the ownership of its stock if the corporation changes the location of a major portion of its activities and as a result of such change of location the business of the corporation is substantially altered." Treas. Reg. § 1.382(a)-1(h)(9); 27 Fed. Reg. 10737 (1962). That statement was immediately

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[3] The Sixth Circuit in *Goodwyn Crockery* refused to give "binding force" to a regulation that was not in effect *either* "at the time the tax liability accrued, *or* at the time of the hearing [before the trial court]." 315 F.2d at 113 (emphasis added). The government incorrectly reads this as a refusal to enforce any regulation that was not in effect "at the time the tax liability accrued;" the government simply ignores the following clause, "or at the time of the hearing." The plain meaning of the court's language, read in its entirety, is that although the court would enforce regulations, whether or not still in effect, that had been in force during the taxable year, and in appropriate circumstances would give retroactive effect to regulations adopted after the taxable year but before the case had been heard, it would not give "binding force" to regulations that satisfied neither criteria.

followed by an example that left no doubt that the corporation in *Goodwyn Crockery* was not to be regarded as having continued substantially the same trade or business.[4] The Sixth Circuit's refusal to give effect to this new regulation determined the result in *Goodwyn Crockery* and therefore was a holding and not just *dictum.*

c. The new regulation in this case, Treas. Reg. § 1.902-3(d)(1) (1975), attributes the income of a foreign subsidiary to the country in which that subsidiary is incorporated.[5] That was not the rule prescribed by the regulations in effect before 1975. Instead, it had been

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[4] Example (1). X Corporation, a calendar-year taxpayer, is engaged in the business of manufacturing in State A and has sustained substantial net operating losses. On June 30, 1958, Y Corporation purchases all of X Corporation's outstanding stock. During 1959, X Corporation transfers its operations to State B which is several hundred miles distant from State A. In order to effect the change in location, X Corporation disposes of its plant and a large portion of its machinery located in State A. The distance between State A and State B makes it necessary for the majority of the employees of X Corporation to terminate their employment with X Corporation. During 1959, X Corporation resumes its manufacturing activities in State B and continues to make the same product and to serve substantially the same group of customers. However, by reason of the changes in location, employees, plant, and equipment, X Corporation, on December 31, 1959, is not carrrying on substantially the same trade or business as that conducted prior to the [change] in ownership.

[5] The government misleadingly implies that the new regulation "had received Congressional approval" (Br. in Opp. 8). The basis for that apparent claim is nothing more than the fact that, at a time when an earlier regulation had set forth the rule reinstated by Treas. Reg. § 1.902-3(d)(1), the Senate Committee on Finance, in describing the then current state of the law, stated that "[i]n the case of a foreign base corporation the Treasury regulations provide that the taxes paid by its subsidiaries are to be treated as if they were paid to the foreign country where the foreign base company is incorporated . . ." [1960] U.S. Code Cong. & Ad. News 3774. The regulations to which the Committee Report refers were repealed effective for taxable years commencing after December 31, 1962. T.D. 6805, 1965-1 Cum. Bull. 38, 52-53.

provided that "[t]he principles of Part I (section 861 and following), subchapter N, Chapter 1 of the Code, and the regulations thereunder shall apply in determining the sources of income for the purposes of [the foreign tax credit provisions]." Treas. Reg. § 1.901-2(d) (1957).

The government seeks to avoid the consequences of this directive by claiming that section 861 *et seq.* and the regulations thereunder "merely gave the basis for determining whether income is to be deemed from sources within or without the United States [and were not] '. . . intended to provide a general principle to be applied in locating a specific foreign country as the source of . . . income'" (Br. in Opp. 14).[6] This bald misstatement is flatly contradicted by the Secretary's own regulations: "The principles applied in §§ 1.861-1 to 1.863-5, inclusive, for determining the gross and taxable income from sources within and without the United States shall be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country . . . ." Treas. Reg. § 1.863-6 (1957).[7] It therefore is clear that prior to the issuance in 1975 of Treas. Reg. § 1.902-3(d)(1), the regulations required determination of the source of foreign income by reference to the princi-

[6] Of course, even if the government's description of these provisions were accurate, it would be irrelevant. Even if section 861 *et seq.* and the regulations thereunder were concerned solely with the principles for determining whether income is from sources within or without the United States, the clear purport of Treas. Reg. § 1.901-2(d) was that, in computing the foreign tax credit, those same principles were also to be used in determining whether income was from sources within or without a foreign country.

[7] Treas. Reg. § 1.863-6 and the regulations to which it refers all were promulgated under "part I (section 861 and following), subchapter N, chapter 1 of the Code." Treas. Reg. § 1.901-2(d) (1957). The language quoted above from Treas. Reg. § 1.863-6 is that in effect during the taxable year 1964. T.D. 6258, 1957-2 Cum. Bull. 368, 386.

ples set forth in section 861 *et seq.* and the regulations thereunder.

The government correctly refrains from disputing the fact that under those principles income is attributable to the country in which it is earned, not to the country of incorporation.[8] The new regulation, if permitted retroactive application, would require attribution of income to the country of incorporation thus negating valid preexisting regulations which during the years in question required attribution of income to the country where such income was earned. Retroactive application of the new regulation to transactions that were completed as much as eleven years before its promulgation would constitute an impermissible administrative "repeal [of] the rule of law that existed during the period for which the tax [was] imposed." *Helvering* v. *R. J. Reynolds Tobacco Co.,* 306 U.S. 110, 116 (1939). See also, *e.g., United States* v. *Alabama Great Southern R.R.,* 142 U.S. 615, 621 (1892).

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[8] The application of those principles is illustrated by Rev. Rul. 76-535, 1976-2 Cum. Bull. 219, and Rev. Rul. 77-86, 1977-1 Cum. Bull. 241, which hold that under section 861 of the Code determination of whether income is derived from within or without a possession of the United States turns on where the income was earned, not the place of incorporation. Precisely the same principles apply "in determining the gross and taxable income from sources within and without a foreign country, or within or without a possession of the United States." Treas. Reg. § 1.863-6. Compare Rev. Rul. 76-535, 1976-2 Cum. Bull. 219, 220-221 with Treas. Reg. § 1.901-2(d). The government's effort to distinguish those rulings (Br. in Opp. 7-8, n.3) is without merit and is misleading.

For the reasons stated here and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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